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TAGS: ECON EFIN HR
SUBJECT: CROATIA'S 2007 BUDGET

¶1. Summary: The Croatian parliament passed the Government's 2007 budget on December 1. The 108 billion kuna (USD 20 billion) budget, representing 40 percent of estimated 2007 GDP, departs from previous years in the distribution of resources to local governments. This change, which will result in a budget cut for the city of Zagreb, was the most controversial aspect of the package and billed by the Government as decentralization. As is customary, the budget passed with ruling-party votes and every opposition-proposed amendment defeated. End Summary.

Deficit Down

¶2. Croatia's 2007 budget of 108 billion kuna (USD 20 billion) was passed by the parliament on December 1. The budget is based on projections of continued GDP growth, which the Government expects to rise to 5 percent in 2007 from a projected 4.6 percent this year. Spending levels will be 8.9 percent higher than in 2006, while revenue is projected to grow by 9.1 percent. The resulting deficit, including those incurred by local governments, is projected at 2.8 percent of GDP, down from 3.0 percent in 2006 and 6.2 percent in
¶2003.

¶3. Falling budget deficits are part of the Government's strategy to align Croatia with the EU Maastricht Criteria, with a view to bringing the country's heavily "euroized" economy into the Eurozone as soon as possible following EU accession. The GOC has been able to bring its deficits down in large part due to a combination of sustained economic growth and a steady squeezing of the still substantial gray economy, both of which have led to rising revenue from the 22 percent valued added tax (VAT).

More for Regions; Less for Zagreb

¶4. The big news for 2007 was the change in the distribution of revenue to local governments. In an effort to direct more resources to municipalities, the Government changed the rules by which corporate taxes are shared. Whereas previously part of corporate tax revenue was apportioned on the basis of where companies were headquartered (nearly all are based in Zagreb), the state will now add these taxes to the general revenue. As a result, most municipalities will see a rise in their budgets, with the exception of Zagreb, which will lose nearly USD 100 million as a result, and the city of Rovinj, in Istria, which also had a disproportionately high share of revenue due to the fact that the national tobacco company has its headquarters there.

¶5. Although some Zagreb politicians have cried foul over the scheme, there is consensus in Croatia that the country is far too centralized, with some commentators pointing out that Zagreb simply replaced Belgrade after independence in appropriating the resources of the regions.

Social Spending 75 Percent of Budget

¶6. Like many countries, Croatia's fixed entitlement spending leaves little room for maneuver in the budget. The healthcare system

suffers chronic losses and the ratio of 1 pensioner to every 1.4 persons employed shows no signs of improving substantially in the near-term. Spending for pensions, government salaries, healthcare and other social spending together accounts for over 80 billion kunas (USD 14.5 billion) or nearly 75 percent of the budget.

Defense Budget Up Slightly

¶7. The 2007 defense budget registers a modest increase over 2006, both in nominal and real terms. The Ministry of Defense is set to receive 4.5 billion kunas (USD 821 million), or about 1.66 percent of projected 2007 GDP. Note: Anticipated repayment of the Russian clearing debt could increase this figure, as well as debt payments not accounted for in the MOD budget line.

Subsidies

¶8. In keeping with past practice, the budget is also laden with subsidies, some being dispensed in anticipation of the impending prohibition on such practices once Croatia joins the EU. Croatian Railways is set to receive 1.5 billion kunas (USD 272 million), agriculture 2.4 billion kunas (USD 436 million), with shipyards, the national airline and others also taking their customary share.

Comment

¶9. Croatia has made solid progress in fiscal consolidation. However, with the IMF on the way out and elections next year, the Government will get the first real test of its sincerity. With ever more optimistic assumptions about GDP growth, a slowdown could alter outcomes dramatically. Furthermore, large parts of the Government's operating revenue still come from privatization receipts. With shares in many of the large and valuable firms already sold, the GOC will need to get more control over its entitlement spending if it

hopes to eliminate its structural deficit.

BRADTKE